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Internal control reporting : implementing Sarbanes-Oxley Act section 404; Financial reporting alerts

Michael J. Ramos

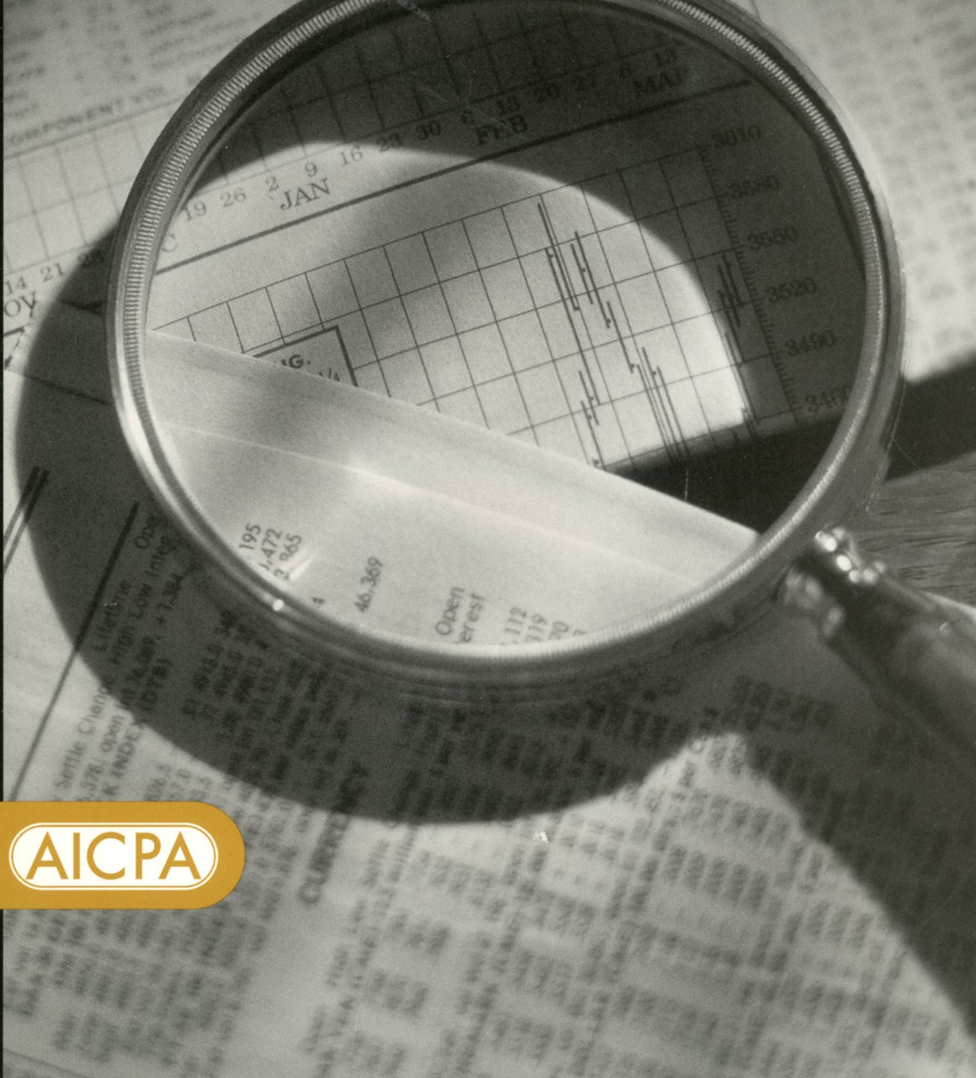
Karin Glupe

FINANCIAL REPORTING ALERTS

Internal Control Reporting

Implementing Sarbanes-Oxley Act Section 404

Revised Edition



American Institute of Certified Public Accountants

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FINANCIAL REPORTING ALERTS

Internal Control Reporting

Implementing Sarbanes-Oxley Act Section 404

Revised Edition

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Written by
Michael J. Ramos, CPA

Edited by
Karin Glupe, CPA
Technical Manager
Accounting and Auditing Publications

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Internal Control Reporting—Implementing Sarbanes-Oxley Act Section 404

Introduction

In July 2002, the Sarbanes-Oxley Act of 2002 (the Act) was signed into law, bringing with it sweeping changes to many aspects of the financial reporting, corporate governance, and regulatory landscape for public companies. Section 404 of the Act requires public companies to include with their annual report to the Securities and Exchange Commission (SEC) a separate report on the assessment of the effectiveness of the entity's internal control. Additionally, the entity's external auditors must attest to and report on the assessment made by management.

A company that is an "accelerated filer" must begin to comply with the internal control reporting and attestation requirements associated with the Act for its fiscal year ending on or after November 15, 2004. According to the SEC, a company is an accelerated filer if its common public equity float was $75 million or more as of the last business day of its most recently completed second fiscal quarter; the company has been subject to the reporting requirements of the Securities Exchange Act of 1934 for at least 12 calendar months; the company has filed at least one annual report; and the company is not a small-business issuer (that is, it is not eligible to use Forms 10-KSB or 10-QSB). By contrast, a nonaccelerated filer does not meet these requirements, and is not required to file its annual and quarterly reports on an accelerated basis. A nonaccelerated filer, or a foreign private issuer that files its annual reports on Form 20-F or Form 40-F, must begin to comply with the internal control reporting and attestation requirements for its first fiscal year ending on or after July 15, 2006.

Since the passage of the Act, many issues have arisen regarding the implementation of the internal control assessment and reporting process. The purpose of this Alert is to articulate significant technical issues that have surfaced and to provide direction for those responsible for managing or participating in the implementation of section 404, including:

- The entity's CEO and CFO, who have the overall responsibility for assessing and reporting on internal control
- Internal auditors
- Third parties who might be engaged by the entity to assist with the assessment process

Summary of Relevant Rules and Other Authoritative Literature

Management's assessment and reporting on internal control is shaped by several key rules and standards, including:

- *SEC rules.* The Sarbanes-Oxley Act directed the SEC to adopt detailed rules to implement the requirements of the Act relating to internal control. These rules define for issuers the requirements for assessing and reporting on internal control. To read the SEC rules, go to the SEC Web site at www.sec.gov/rules/final/33-8238.htm.
- *External auditor standards.* These standards describe the approach, required tests, and other guidance that the entity's external auditors are expected to follow when reporting on management's assertion about the effectiveness of internal control. These standards do not affect the issuer directly, but they do have a significant *indirect* effect on the procedures performed by management.
- *The Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Integrated Framework.* Management's report on internal control effectiveness is required to disclose the criteria against which management assesses effectiveness. The COSO framework is one example set of criteria and it is anticipated that most U.S. entities will use COSO in their evaluation. To obtain the COSO framework, call the AICPA at (888) 777-7077 or

visit www.cpa2biz.com and order *Internal Control—Integrated Framework* (product no. 990012kk).

The SEC Rules

The SEC issued its final rule on management's report on internal control in May 2003, and the rule became effective on August 14, 2003. It is the entity's annual report to the SEC (Form 10-K) that contains management's report on internal control, and therefore it is the SEC rules regarding those reports that management must follow in planning and performing its assessment of control effectiveness.

Definition of *Internal Control*

The SEC rules clarify that management's assessment and report are limited to *internal control over financial reporting*. Management is not required to consider other aspects of control, such as controls pertaining to operating efficiency. The SEC's definition of *internal control* encompasses the COSO definition (described later in this Alert in the section titled "The COSO Internal Control Integrated Framework"), but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

Annual Reporting Requirements

Under the SEC rules, the company's annual 10-K must include:

1. *Management's Annual Report on Internal Control Over Financial Reporting.* This report on the company's internal control over financial reporting should contain:
   a. A statement of management's responsibilities for establishing and maintaining adequate internal control over financial reporting.
   b. A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting.
   c. Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether or not internal control over finan-

cial reporting is effective. This discussion must include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

d. A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

2. *Attestation Report of the Registered Public Accounting Firm.* This is the registered public accounting firm's attestation report on management's assessment of the company's internal control over financial reporting.

3. *Changes in Internal Control Over Financial Reporting.* This report must disclose any change in the company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the company's internal control over financial reporting.

Key provisions of these reporting requirements that merit management's consideration include the following.

- *"As of" reporting*. Management assesses the effectiveness of internal control as of the end of the fiscal year, rather than throughout the reporting period. This reporting requirement has significant implications for the reporting of material weaknesses that were identified and corrected during the period. It also affects the timing of management's tests of the design and operating effectiveness of controls.

- *Material weakness in internal control.* Management is required to disclose any material weakness[1] in the company's

1. For a definition of *material weakness*, see the "Reporting" section of this Alert.

internal control. Further, the existence of one or more material weaknesses precludes management from concluding that its internal control is effective.

Both of these considerations are discussed in more detail in the section titled "Reporting" in this Alert.

Quarterly Reporting Requirements

The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

Additionally, management is required to evaluate the effectiveness of the entity's "disclosure controls and procedures" and issue a report as to their effectiveness on a quarterly basis. With these rules, the SEC introduced a new term, *disclosure controls and procedures*, which differs from *internal controls over financial reporting* and is much broader.

As defined, disclosure controls and procedures encompass the controls over all material financial *and nonfinancial information* in Exchange Act reports. Information that would fall under this definition that would *not* be part of an entity's internal control over financial reporting might include the signing of a significant contract, changes in a strategic relationship, management compensation, or legal proceedings.

This Alert does not discuss the evaluation of disclosure controls and procedures but is limited to a discussion of the annual and quarterly evaluation and reporting of internal control over financial reporting.

External Auditor Standards

The entity's external auditors are required to audit management's internal control report in accordance with certain professional standards. These standards *directly* affect *only* the work of the external auditor. The work performed by the entity to assess the effectiveness of its internal controls need only comply with the requirements of the SEC rules. However, the auditing standards related to internal control reporting will have a *significant indirect* effect on the way in which management plans and performs its internal control testwork. For example, the standards may require the external auditors to include certain divisions, categories of controls, or control procedures within the scope of their work. If that is the case, management would need to ensure that the scope of their assessment process is congruent with the requirements of external auditors.

Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Conducted in Conjunction With an Audit of Financial Statements*

In June 2004, the SEC approved Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2. This standard is effective for audits of internal control over financial reporting required by section 404 of the Sarbanes-Oxley Act of 2002 and addresses several important areas that affect financial statement issuers. A brief discussion of these follows.

The Audit Process. The overall objective of the external auditor's engagement is to form an opinion about management's assessment of the effectiveness of internal control. To form his or her opinion, the auditor:

- Evaluates the reliability of the process used by management to assess the entity's internal control and assesses the adequacy of the company's documentation of internal control. Lack of adequate documentation is considered a control deficiency that may preclude an unqualified opinion on internal control or may result in a scope limitation on the auditor's engagement.
- Confirms his or her understanding of the entity's internal control by performing walk-throughs of the company's significant processes. A walkthrough is a procedure in which a transaction is traced from its origination through the information processing system, to the transaction's reporting in the financial statements.

- Reviews and relies on the results of *some* of the tests performed by management, internal auditors, and others during their assessment process.
- Performs his or her own tests.

This framework of the auditor's process poses several important questions for management, including:

- What are the qualities of management's process for assessing internal control that the external auditors deem necessary to make the process "reliable"?
- Which of management's tests can the external auditor rely on and which are subject to retesting by the auditor?

Required Elements of Management's Process. The standard provides guidance on the *required* elements of management's process for assessing the effectiveness of internal control. The absence of one or more of those required elements may result in a modification to the standard audit report. For this reason, it is critical that management's process comply with all requirements established by the new standard.

The auditing standard states that the auditor should determine whether management's assessment process has addressed the following elements.

- Determining which controls should be tested, including controls over relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:
  - Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.
  - Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.
  - Antifraud programs and controls.
  - Controls, including information technology general controls, on which other controls are dependent.

- Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.
- Company-level controls, including the control environment.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorize, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

- Evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives.
- Determining the locations or business units to include in the evaluation for a company with multiple locations or business units.
- Evaluating the design effectiveness of controls.
- Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. To evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated controls over all relevant assertions related to all significant accounts and disclosures.
- Determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses.
- Communicating findings to the auditor and to others, if applicable.
- Evaluating whether findings are reasonable and support management's assessment.

Documentation of Testwork to Support Management's Assertion. The standard provides additional guidance on the nature and extent of the documentation required by the entity to support management's assessment of internal control. The form and extent of documentation should vary depending on the size, nature, and complexity of the company. The standard also states that inadequate documentation is a control deficiency that may rise to the level of a material weakness.

The standard also addresses other situations that are likely to occur in practice, including:

- *Extent of testing of multiple locations, business segments, or subsidiaries.* To determine the locations or business units that should be tested, management should evaluate their relative financial significance and the risk of material misstatement arising from them. Management should also determine the other locations or business units that, when aggregated, represent a group with a level of financial significance that could create a material misstatement in the financial statements.

- *Required tests when the entity uses a service organization to process transactions.* Management should obtain an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization. Management should also obtain evidence that the controls that are relevant to management's assessment are operating effectively.

- *Updated testwork required when the original testing was performed at an interim date in advance of the year-end reporting date.* Generally, as the risk associated with the control being tested decreases, the testing may be performed farther from the as-of date; on the other hand, as the risk associated with the control increases, the testing should be performed closer to the as-of date.

Appendix B of Auditing Standard No. 2 provides further information regarding these situations.

Using the Work of Internal Auditors and Others. Many entities are using the work of their own internal audit staff and others within the organization to perform tests of the effectiveness of internal control. At issue is the extent to which the external auditors can rely on those tests to reach their own conclusion.

Paragraphs 108 through 126 of the standard provide extensive guidance on the degree to which the company's work on internal control can be used by the external auditors. The standard indicates that the work of "others" includes the relevant work performed by internal auditors, other company personnel, and third parties working under the direction of management or the audit committee. However, the external auditor "must perform enough of the testing himself or herself so that the [external] auditor's own work provides the principal evidence for the [external] auditor's opinion."

There are two areas where the external auditors are prohibited from using the company's work in their audit.

- *Control environment.* The external auditors are prohibited from using the work of company management and others to reduce the amount of work they perform on controls in the control environment. However, the external auditor should still "consider the results of work performed in this area by others because it might indicate the need for the [external] auditor to increase his or her [own] work."
- *Walkthroughs*. External auditors are required to perform at least one walkthrough for each major class of transactions.

For all areas other than the control environment and the walkthroughs, the external auditors may use the company's tests on internal control during their audit. To determine the extent to which the external auditor may use the company's work, the external auditor is required to:

- Evaluate the nature of the controls subjected to the work of others;
- Evaluate the competence and objectivity of the individuals who performed the work; and

- Test some of the work performed by others to evaluate the quality and effectiveness of their work.

The auditor should evaluate the following factors when evaluating the nature of the controls subjected to the work of others. As these factors increase or decrease in significance, the need for the auditor to perform his or her own work on those controls increases or decreases, respectively.

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.
- The degree of judgment required to evaluate the operating effectiveness of the control.
- The pervasiveness of the control.
- The level of judgment or estimation required in the account or disclosure.
- The potential for management override of the control.

The extent to which the external auditors can use the company's work depends on the degree of competence and objectivity of the individuals performing the work. The more objective and competent the individuals who performed the work, the more the external auditors can rely on such work. Factors concerning the competence of the individuals performing the tests of controls include their educational level and professional experience, their professional certification and continuing education, practices regarding the assignment of individuals to work areas, supervision and review of their activities, the quality of the documentation of their work, and the level of supervision and review of their activities. Factors concerning the objectivity of the individuals performing the tests of controls include the following: if the individuals responsible for the work of others (testing authority) in testing controls reports to an officer of sufficient status to ensure sufficient testing coverage and appropriate action on findings and recommendations of the individuals performing the testing; if the testing authority reports regularly to the board of directors or audit committee; and if there are policies prohibiting individuals from testing controls in areas to which they were recently assigned, or areas in which relatives are employed.

The auditing standard notes that the work of internal auditors may be used "to a greater extent than the work of other company personnel." This is particularly true for internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing*, issued by the Institute of Internal Auditors. According to the standard, "if internal auditors have performed an extensive amount of relevant work and the auditor determines they possess a high degree of competence and objectivity, the auditor could use their work to the greatest extent an auditor could use the work of others."

Documentation of Internal Control. The external auditors evaluate the adequacy of management's documentation of internal control. Paragraph 42 of the auditing standard states that when determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation includes the following:

- The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting, including the control environment and company-level controls.
- Information about how significant transactions are initiated, authorized, recorded, processed, and reported.
- Sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur.
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties.
- Controls over the period-end financial reporting process.
- Controls over safeguarding of assets.
- The results of management's testing and evaluation.

As management documents internal control, they should be aware of what elements their auditors will be looking for and ensure that those elements are present.

Seeking Help From External Auditors—Independence Issues. The auditing standard incorporates four basic principles in its guidance on independence when performing an audit of internal control. These basic principles state that independence would be impaired if the auditor's services to the company create a mutual or conflicting interest between the firm and the client, place the firm in a position where it subsequently audits its own work, result in the firm acting as an employee of the client, or result in the firm acting as an advocate for the client.

Maintaining independence is primarily the responsibility of the external auditors. However, note that several of the independence requirements impose certain responsibilities on management and the audit committee.

- *Preapproval by the audit committee.* Any internal control-related service to be provided by the external auditor must be preapproved by the audit committee. There is no grandfathering for ongoing internal control-related engagements that were preapproved before the effective date of Auditing Standard No. 2 in a manner that would not satisfy the requirements in the standard.
- *Active involvement of management.* Management must be "actively involved" in a "substantive and extensive" way in all internal control services the external auditor provides. Management cannot delegate these responsibilities, nor can it merely accept responsibility for documentation and testing performed by the auditors.
- *Independence in fact and appearance.* According to the standard, the test for independence in fact is whether "the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements or internal control over financial reporting." The test for independence in appearance, according to the standard, is "whether a reasonable investor … would perceive an auditor as having interests which could jeopardize the exercise of objective and impartial judgments on all issues … within the auditor's engagement."

Additional Guidance. Subsequent to the approval of the standard, both the PCAOB and the SEC released documents of answers to frequently asked questions (see the Appendix of this Alert for the SEC questions and answers). These documents set forth the PCAOB and SEC staff's opinions and views on certain matters. Although the PCAOB and the SEC point out that these opinions and views do not represent official "rules," any departure from the answers to questions discussed in these documents should be justified. In addition, the auditing standard can be downloaded directly from the PCAOB Web site at www.pcaobus.org/Standards/index.aspx.

The COSO Internal Control Integrated Framework

In 1985, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) was formed to sponsor the National Commission on Fraudulent Financial Reporting, whose charge was to study and report on the factors that can lead to fraudulent financial reporting. Since this initial undertaking, COSO has expanded its mission to improving the quality of financial reporting. A significant part of this mission is aimed at developing guidance on internal control. In 1992, COSO published *Internal Control—Integrated Framework*, which established a framework for internal control and provided evaluation tools that business and other entities could use to evaluate their control systems. This COSO report can be obtained through the AICPA by calling (888) 777-7077 or by going online at www.cpa2biz.com (product no. 990012kk).

The COSO Internal Control Components

The COSO framework describes five interrelated components of internal control.

- *Control environment.* Senior management must set an appropriate "tone at the top" that positively influences the control consciousness of entity personnel. The control environment is the foundation for all other components of internal control and provides discipline and structure.

- *Risk assessment.* The entity must be aware of and deal with the risks it faces. It must set objectives, integrated throughout all value chain activities, so the organization is operating in concert. Once these objectives are set, the entity must then identify the risks to achieving those objectives, analyze those risks, and develop ways to manage them.
- *Control activities.* Control policies and procedures must be established and executed to help ensure the actions identified by management as necessary to address risks are effectively carried out.
- *Information and communications.* Surrounding the control activities are information and communication systems, including the accounting system. These systems enable the entity's people to capture and exchange the information needed to conduct, manage, and control its operations.
- *Monitoring.* The entire control process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant.

The COSO report describes these individual components as being tightly integrated with each other. Each component has a relationship with and can influence the functioning of every other component. When evaluating the effectiveness of internal control, management should consider it as an integrated whole. Weak controls in one area can be offset by stronger controls in another area.

Key Characteristics of the COSO Framework

Flexible, Adaptable, No "One Size Fits All" Approach

The COSO framework is not a rigid, prescriptive approach to internal controls. It recognizes that different entities make different choices about how to control their businesses. Internal control is not a "one size fits all" proposition. Consequently, internal control cannot be evaluated against a detailed set of fixed, required procedures. Management has to exercise a great deal of judgment, driven by the particular needs of the entity, to determine the nature of the controls in place and whether they are functioning effectively.

Effectiveness Determined by Achievement of Objectives

Management should judge the effectiveness of internal control by how well the controls enable the entity to achieve stated objectives. Controls have value only to the degree to which they allow the entity to achieve its objectives. Thus, the COSO framework adopts a business objectives-driven approach to defining internal control. Under that approach, the entity:

1. Establishes business objectives. The SEC rules describe those objectives as relating to the preparation of reliable financial statements.

2. Identifies the risks to achieving those objectives.

3. Determines how to manage the identified risks. The establishment of internal controls is just one of several options.

4. Where appropriate, establishes control objectives as a way to manage certain risks. Individual controls are then designed and implemented to meet the stated control objectives.

Significant Control Objectives

The COSO framework focuses on the achievement of control *objectives* (rather than the existence of predetermined control procedures), and it is expected that management will rely on some control procedures more than others to achieve these objectives. For example, management may decide to rely more on detective controls rather than preventive controls to identify and correct unauthorized transactions. At the entity level, some control objectives or activity-level processing streams may be more significant to the entity's financial statements or financial reporting process than others.

When assessing the effectiveness of internal control *as a whole*, management should be sure to identify the controls it relies on most to produce reliable financial statements, and to include the testing of these controls in the scope of its work.

The Importance of the Control Environment

Managers typically think of internal control only in terms of the policies and procedures related to the processing of transactions. For example, the matching of a vendor invoice to a master file of approved vendors, the recalculation of that invoice, or the reconciliation of the accounts payable subsidiary ledger to the general ledger account are all examples of controls over the processing of purchases.

The COSO framework does not limit itself to these types of business activity-level procedures. The framework acknowledges that the *environment* in which those procedures operate has a direct effect on their effectiveness. In fact, this environment is described as the foundation of all other control components. The control environment encompasses the following:

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

When evaluating the effectiveness of internal control, management must be sure to perform tests that allow it to assess the effectiveness of the control environment. The section of this Alert titled "Testing of Internal Control" discusses this matter in more detail.

Antifraud Programs and Controls. Management is responsible for designing and implementing systems and procedures for the prevention and detection of fraud and, along with the board of directors, for ensuring a culture and environment that promote honesty and ethical behavior. Broadly stated, three fundamental elements are essential when implementing a system to prevent, deter, and detect fraud. They are: (1) create and maintain a culture of honesty and high ethics; (2) evaluate the risks of fraud and implement the processes, procedures, and controls needed to mitigate the risks and reduce the opportunities for fraud; and (3) develop an appropriate oversight process. The AICPA Antifraud & Corporate Responsibility Resource Center provides extensive guidance for developing antifraud programs and controls.

Reasonable Assurance

No matter how well designed or operated, internal control can provide only reasonable assurance that objectives will be met. Reasonable assurance is a high threshold, but it stops short of absolute assurance. The presence of an internal control failure does not, in and of itself, mean that a system is ineffective. The COSO report states that "even an effective internal control system can experience failure."

Information Technology Considerations

The COSO framework groups information technology (IT)-related controls into two types: general computer controls and application-specific controls.

- *General controls* include controls over:
  - Data center operations (for example, job scheduling, backup, and recovery procedures)
  - Systems software controls (for example, the acquisition and implementation of operating systems)
  - Access security
  - Application system development and maintenance controls (for example, the acquisition and implementation of individual computer software applications)
- *Application controls* are designed to control information processing and help ensure the completeness and accuracy of transaction processing, authorization, and validity. Application controls also encompass the way in which different applications interface with each other and exchange data.

The COSO report does not mandate this approach to assessing the effectiveness of internal controls but states that this is one set of groupings of IT-related control activities that can be used.

Many entities will find the COSO guidance on IT-related controls to be insubstantial and may look for additional guidance. The Control Objectives for Information and Related Technology (COBIT) framework is a good source for such guidance.

The COBIT Framework

Since the release of COSO, the Information Systems Audit and Control Association and Foundation (ISACA) has developed its COBIT framework, which provides a generally applicable and accepted standard for IT security and control practices. Among IT audit professionals, COBIT is widely accepted.

The COBIT framework is similar to COSO in that it puts controls within the context of an entity's need to achieve certain business objectives and the risks it faces toward achievement. In defining the goals of IT governance and control, COBIT takes a rather broad brush and does not limit itself to the financial reporting process. For the purpose of complying with the SEC internal control reporting requirements, management should limit its consideration of IT controls to those that affect the reliability of financial reporting, either directly (for example, application controls) or indirectly (for example, general controls).

COBIT groups the IT processes into four categories, each of which is critical in delivering information that meets certain stated criteria.

- *Planning and organization.* These processes cover strategy and tactics and concern the identification of the way IT can best contribute to the achievement of stated business objectives, both now and in the future.
- *Acquisition and implementation.* To realize the IT strategy, IT solutions need to be identified, developed, or acquired, as well as implemented and integrated into business processes.
- *Delivery and support.* These processes include the actual processing of data by application systems.
- *Monitoring.* All IT processes need to be regularly assessed over time for their quality and compliance with control requirements.

The delivery and support category of processes is analogous to the COSO category of application controls. The other categories identified by COBIT approximate the general controls described by COSO but are somewhat broader in scope.

AICPA Trust Services, Including SysTrust℠ and WebTrust℠

SysTrust and WebTrust are professional services that address areas such as security, privacy, processing integrity, availability, and confidentiality through the use of the AICPA/CICA Trust Services Principles and Criteria. Management can benefit from using these suitable criteria in several ways when implementing Sarbanes-Oxley section 404 requirements. They can use the AICPA/CICA Trust Services Principles and Criteria as:

1. A guideline to setting up appropriate controls and systems that will instill confidence and trust.
2. A method of evaluating a system to determine whether it meets specific criteria and employs best practices.
3. An internal method of assurance and self-assessment that management, the board, and others can rely upon.

For more information about Trust Services, visit AICPA Online at www.aicpa.org/trustservices.

Project Planning Considerations

To reach a reliable conclusion about the effectiveness of the entity's internal control, management will need to plan a logical, structured approach to its testing and evaluation, for example:

1. Ensure adequate documentation of existing controls. If controls are found to be missing or to contain design deficiencies, new or redesigned controls need to be documented and implemented.
2. Perform tests of the design and operating effectiveness of all significant controls.
3. Evaluate the test results and form a conclusion about the effectiveness of internal control. If the tests reveal signifi-

cant deficiencies or material weaknesses in internal control, corrective action should be taken immediately.

4. Prepare management's report on internal control.

General Planning Considerations

During the course of the project to assess internal control effectiveness, management will be required to make important judgments regarding:

- The focus of testing and areas of risk requiring increased scrutiny
- The nature of the testwork and other procedures necessary to achieve the project's objectives
- The scope of the work to be performed, for example, the locations or business units to be included in testing

Planning involves gathering information to help make broad, preliminary judgments on these matters. The knowledge gained from gathering this information also provides the requisite knowledge to make informed decisions as the engagement proceeds. In that sense, planning is an ongoing process. Preliminary judgments made at the onset of the project are revisited continuously as the project progresses and more information becomes available.

Information Sources

Sources of information that are useful for planning an assessment of internal control include the following:

- Published sources such as:
  - Form 10K and other SEC filings
  - Annual report
  - Information available in the Investor Relations section of the entity's Web site
  - Analyst reports
- Inquiries of key individuals with knowledge of the entity's most significant business processes and financial reporting processes and how these processes are monitored and controlled.

Areas of Focus

The tests of control effectiveness should be focused on the entity's most significant control objectives. Determining these control objectives is largely a matter of judgment that requires management to consider the most significant risks of producing reliable financial statements and the controls that mitigate these risks. The use of a percentage or other quantitative threshold may provide a reasonable basis for evaluating the significance of an account or process; however, judgment, including a review of qualitative factors, should be used to determine if amounts above or below the quantitative threshold must be evaluated. Factors that management should consider include the following:

- The entity's most significant business process activities
- Significant risks facing the entity and the industry
- Significant accounts, classes of transactions, and disclosures in the entity's financial statements
- Areas that pose a high risk of material misstatement to the financial statements, including those that:
  - Have a known or suspected control weakness
  - Possess a high risk for material misstatement irrespective of any controls

Management should be careful not to make the assessment a "check-the-box" exercise. An assessment of internal control that is too formulaic or too detailed may not fulfill the underlying requirements. The desired approach should be to focus resources on the areas with the greatest risk, and avoid giving all significant accounts and related controls equal attention without regard to risk.

For future years' assessments of internal controls, management's knowledge of the prior year's assessment results affect its current year risk-based analysis of the significant accounts and the related required documentation and testing. Management may determine that certain controls require more extensive testing, while other controls require little testing. Management may also find it appropriate to adjust the nature, timing, and extent of testing from year to year, by performing extensive tests in selected internal control areas some years, while performing less extensive testing in other areas, and changing that focus from year to year.

Management Override of Controls

Assessing internal control effectiveness may necessitate addressing the key area of management override of controls, a characteristic of many fraudulent financial reporting schemes. The audit committee plays an important role in helping the board of directors fulfill its oversight responsibilities with respect to the entity's financial reporting process and the system of internal control. In exercising this oversight responsibility, the audit committee should consider the potential for management override of controls or other inappropriate influence over the financial reporting process.

Structuring the Project Team

Performing an assessment of internal control is a complex process. Management should assemble a project team that includes individuals with a wide variety of technical expertise, including the following:

- Financial reporting requirements and processes
- Operations management
- Auditing concepts, techniques, and tools
- Information technology
- Securities law and SEC reporting requirements

Members of the project team should have sufficient authority and stature within the organization to allow them access to information and resources. The team should report directly to the CEO and CFO, who ultimately bear the responsibility for establishing and maintaining internal control and reporting on its effectiveness.

Engaging Third Parties for Assistance

Entities that lack sufficient resources or expertise may look to third parties for assistance. Completely outsourcing the entire project to a third party normally would be inappropriate for management to do—ultimately, management should remain responsible for evaluating and reporting on the effectiveness of the entity's internal control. However, third parties may be engaged to participate as part of the project team or to provide other services such as training.

When engaging third parties for help on the project, management should clarify with the third party:

- *Qualifications*. This includes the nature of their expertise and their experience in performing the work you will ask of them.
- *Scope of work.* Management should be sure to define, as unambiguously as possible, the scope of the third party's work. For example, if the entity engages a third party to assist "in the documentation of internal control," what does that entail? Is that limited to the preparation of documentation for controls already in existence? What if, during this process, management discovers that some necessary controls do not exist or the ones that do are inadequately designed? Is the design or redesign of controls within the original scope of work?
- *Work product.* The work performed by a third party may result in evidence used by management to support its assessment of internal control effectiveness. As such, the external auditors also may rely on some or all of the work to reach their conclusion about management's assertion. When engaging third parties, management should obtain a clear understanding about the form and content of the work product to ensure that it is suitable for their purposes and, if necessary, acceptable for use by the external auditors.

Working With the External Auditors

Management's relationship with its external auditor will play a role in determining effectiveness, efficiency, and cost of the project. Particularly in the first year of implementation, the entity's efforts to assess internal control effectiveness should be closely coordinated with the needs of the external auditor. A lack of coordination with the auditors could result in a variety of negative, unforeseen consequences, including:

- Duplication of effort
- Reperformance of certain tests
- Performance of additional tests or unanticipated expansion of the scope of the engagement
- Misunderstandings relating to the definition or reporting of material weaknesses.

Issues to Consider With the External Auditors

The communication between management and the external auditors should take place early and continue throughout the project. Many issues arise during the course of the project. For some of these issues, the input of the external auditors is important if management is to reach a suitable resolution. Issues that management should consider discussing with its external auditors include the following.

Project Planning

- The overall process and approach management will take to evaluate internal control effectiveness
- The scope of the project
- The degree to which the external auditors will rely on the results of management's test work to reach their conclusion
- The list of controls determined to be significant and, therefore, the primary focus of the project
- The use of service centers and reliance on service center reports

Documentation

- Documentation of internal control policies and procedures, including the form of the documentation and what the documentation will contain
- The nature and extent of the documentation of tests of controls

- How to determine whether documentation of controls and tests of controls is sufficient

Tests of Internal Control

- The nature and extent of the planned tests of controls and whether the evidence expected to be obtained in those tests is sufficient to allow management to draw a reliable conclusion about the design and operating effectiveness of internal control
- The general type of deviations or conditions that might be considered significant deficiencies or material weaknesses[2] and therefore should be considered when designing tests of controls; the planned timing of management's tests of controls and whether this timing will allow management to draw conclusions about the design and operating effectiveness of internal control "as of" year end
- The nature and extent of procedures that may be required to update management's conclusions about effectiveness from the time the procedures were performed until year end
- The results of management's tests of controls and the conclusions reached regarding the effectiveness of internal control

Reporting

- Contents of management's report on internal control, including:
  - Completeness of the report and whether the contents satisfy the SEC reporting requirements
  - Possible deletion of material that is not required
- Disclosure of material weaknesses that exist at the reporting date
- The nonreporting of material weaknesses that existed and were reported at an interim period but subsequently have been remediated

2. See definitions of *significant deficiencies* and *material weaknesses* in the "Reporting" section of this Alert.

- Disclosure of significant control changes that occurred after year end

Auditor Independence

To perform an audit of an entity's financial statements, the external auditor must be independent of the entity. The SEC has developed a detailed body of rules that define auditor independence. Underlying these detailed rules are fundamental concepts of independence, including:

- Auditors should not act in the capacity of management.
- Auditors should not audit their own work.

The audit committee should proceed carefully when engaging the entity's external auditors to assist in management's internal control assessment process. The nature of the relationship and scope of work should be defined in a way that the auditor's independence both in appearance and in fact remains uncompromised. The audit committee or board of directors should be involved in all discussions and have the final authority for determining whether and how the external auditors will be engaged to assist in any internal control related matters. The consequences of violating the SEC's auditor independence rules may be severe, and in some cases, the SEC may even require the entity to have its financial statements reaudited.

Documentation of Internal Control and Tests of Controls

Within the context of assessing internal control to comply with the SEC reporting requirements, there are two separate sets of documentation:

- Documentation of the entity's internal control policies and procedures
- Documentation of management's tests to support its conclusion about the design and operating effectiveness of those controls

Documentation of Internal Control Policies and Procedures

The adequate documentation of internal control is important for the following reasons.

- *To improve reliability of internal control.* The documentation of an entity's internal control policies and procedures improves the effectiveness and reliability of the system. Without adequate documentation, the performance of the system depends exclusively on the skills and competence of the individual responsible for performing the procedure. As such, performance can vary greatly between individuals or over time. Adequate documentation reduces this variability by facilitating the consistent dissemination of critical information. Additionally, by clearly stating the parameters within which control procedures should be performed, it becomes easier to identify deviations from the policy or procedure—that is, material weaknesses can be identified.
- *To enable effective monitoring.* Management is required to report material changes in internal control on a quarterly basis. As a result, one of the most important features of the monitoring component of the entity's internal control system is its ability to identify changes. Documentation facilitates this monitoring element.

In addition to enhancing the overall effectiveness of internal control, documentation of control policies and procedures also will facilitate management's assessment of effectiveness by providing a basis for:

- Evaluating design effectiveness
- Planning tests of operating effectiveness

Management should be careful to distinguish between the documentation of internal control and internal control itself. Creating a document that describes the control policies and procedures that should be followed is *not* internal control. Internal control is the *process* used by the *people* to carry out those documented policies and procedures.

The mere documentation of a control policy or procedure provides *no evidence* to support the operating effectiveness of the control. To support a conclusion about effectiveness, management needs to gather evidence by performing tests of controls.

Assessing the Adequacy of Existing Documentation

Many entities currently are involved in projects to assess the adequacy of their existing documentation of internal control. In assessing the adequacy of documentation, management should determine whether:

- *All significant controls objectives have been considered.* As described previously, some control objectives, policies, and procedures are more significant to the entity's overall internal control structure than others. When considering the adequacy of an entity's documentation of internal control, individual policies and procedures should be documented for all significant control objectives. If control policies have not been documented for certain significant control objectives, management must determine whether:
  - Controls do not exist to achieve the stated control objective, in which case the entity must design, implement, and document new control procedures, or
  - Controls exist to achieve the control objective; however, they are informal, communicated verbally, or otherwise not documented. In this case, suitable documentation must be developed to facilitate an evaluation of the effectiveness of the design of the control.
- *Documentation is sufficient.* To be sufficient, the documentation should allow management and the external auditor to:
  - Determine whether the policy or procedure is adequately designed
  - Design and perform procedures to test the operating effectiveness of the controls

Documenting the Control Environment

The documentation of the entity's control environment should encompass all the control environment elements described in COSO and summarized in "The Importance of the Control Environment" in the "Key Characteristics of the COSO Framework" section of this Alert. Those elements usually are described in documents such as:

- Board of directors' charter
- Audit committee documents and charter
- Company code of conduct
- Disclosure committee[3] charter
- Human resource policies and personnel handbook

Documentation can also encompass the elements essential in management's antifraud programs and controls.

Documenting Activity Level Control Policies and Procedures

The documentation of controls related to transaction processing streams should contain the following elements.

- A link between the control objective and the control policy or procedure
- A description of the control policy or procedure that achieves the control objective
- A description of:
  - How the control procedure is to be applied
  - Who is responsible for performing the procedure
  - How frequently the procedure is performed

There are no requirements for the form of the documentation. There are many different acceptable ways to document control policies and procedures, including narratives, "walk through" descriptions of key documents, and flowcharts. Computerized documentation tools may be used to facilitate this process.

3. As described in the section of this Alert titled "The SEC Rules," management is required to report on the effectiveness of the entity's disclosure controls and procedures on a quarterly basis. The SEC has recommended that entities form a disclosure committee to comply with this requirement.

Documentation of Tests of Controls

The entity should document the tests performed and evidence obtained to evaluate both the design and operating effectiveness of internal control. This documentation serves two purposes.

- It provides the CEO and CFO with the information needed to make and support their assessment of the effectiveness of internal control.
- It may be used, at least in part, by the external auditors to reach their conclusion about management's assertion.[4]

No definitive guidance on the form or content of the entity's documentation of its tests of controls currently exists. However, one might expect such guidance to address matters such as the following:

- The objective of the tests performed
- A description of the test performance, including:
  - The scope of the procedures, for example, the number of transactions tested or business segments reviewed
  - When the tests were performed or the period covered by the tests
  - Who performed the tests
- The results of the tests
- The conclusion reached as a result of the tests performed

Automated Documentation Tools

Since the passage of the Sarbanes-Oxley Act, many companies have developed computer software products that aid in complying with the internal control provisions of the Act. These software tools typically center on helping companies automate the docu-

4. The degree to which the external auditors may rely on tests performed by the entity to evaluate the effectiveness of internal control is a matter that is addressed in Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Conducted in Conjunction With an Audit of Financial Statements*, as discussed in the section of this Alert titled "External Auditor Standards."

mentation of internal control policies and procedures, although some products perform additional functions such as automating the testing and reporting on internal controls, business process activities (for example, the approval and payment of vendor invoices), or both.

The first function of an automated tool typically is to serve as a repository for all the documentation relating to the design of internal control. In those instances where the documentation of the control or the control itself either does not exist or otherwise is deficient, the software may allow the company to efficiently (1) document existing policies or (2) design and document new ones.

Documentation Process

Automated internal control documentation tools typically use a combination of the following methods for creating and accumulating internal control documentation.

- *Reference existing documentation.* In many instances, the documentation of a policy or procedure already exists, for example, human resource policies or personnel manuals. When that is the case, the automated tool will allow this existing documentation to be accessed and reviewed by the user. To allow for this sharing of existing information, the automated tool may have to:
  - Interface with existing systems
  - Import existing data
- *Menu-driven responses.* To create documentation for a new or existing control procedure, the automated tool may provide users with choices from a pull-down menu. For example, to describe a control objective, the user may be presented with a choice of "ensure proper authorization of transactions," "verify accuracy," "ensure the capture of all valid transactions," and so on.
- *Free responses.* Instead of choosing from a predetermined list of possibilities, users may enter their own response into a text box.

Regardless of the method used to document new or existing controls, the goal remains the same—to accurately describe the entity's control policies and procedures as they currently exist. Whether that goal is achieved depends primarily on the user's qualifications, knowledge, and training. To effectively document the entity's control policies and procedures, the user should have an in-depth understanding of all of the following:

- The entity's operations and existing control policies and procedures
- Internal control concepts, as described in the COSO framework (or other framework, if the entity does not use COSO)
- The financial reporting process
- The assertions that are represented in the financial statements[5]

Maintaining Information Integrity

To be effective, management must be able to rely on the accuracy of the documentation maintained. To achieve this integrity, the automated tool should have the following features.

- *Logical access controls.* The ability to modify documentation should be tightly controlled in the same way that access to all of an entity's sensitive information and computer applications is controlled. Individual users should be granted access privileges only to those areas of documentation that pertain to their assigned responsibilities. These access privileges should be administered carefully.

5. Financial statement assertions are described in the auditing literature as the assertions that are embodied in an entity's financial statements. For example, implicit in the financial statements is the assertion that the statements present *all* transactions and that only bona fide, authorized transactions are included. The five financial statement assertions are completeness, existence or occurrence, valuation, rights or ownership, and presentation and disclosure. A working knowledge of these assertions will help users understand risks and related controls. For example, there is a risk that the entity will fail to capture and process all valid transactions (completeness assertion). Therefore, a control objective of the entity's system should be to ensure completeness.

- *Standardized updating procedures.* As with any database, changes to data—in this case, the documentation of internal control—should be monitored and controlled. Modifications to the documentation should be done in an orderly fashion that ensures that all required changes are made. Once the changes have been made, they should be reviewed.

Monitoring Documentation Changes

Once the documentation warehouse becomes established as an accurate reflection of internal control, and standardized updating procedures are in place, any changes to the documentation should represent actual changes to internal control. Management is required to report material changes in internal control. Identifying and capturing changes to the internal control documentation will enable this requirement to be met.

The automated documentation tool should have a means for identifying changes since the last reporting date. To help reviewers evaluate their significance, these changes should be able to be grouped in a variety of ways, including business process, control objective, and financial statement account grouping.

Testing of Internal Control

Management's tests of internal control should be:

- *Complete*. If the COSO criteria are used to measure internal control effectiveness, all five components of internal control, including the control environment, should be tested.

- *Sufficient*. The scope and extent of the tests should be sufficient for management to draw a reliable conclusion about the overall effectiveness of internal control taken as a whole.

- *Timely*. The timing of the tests, or the time period covered by the tests, should allow management to draw a reliable conclusion about the effectiveness of controls as of the reporting date, that is, fiscal year end.

Additionally, the entity should address both the design and the operating effectiveness of the control.

- *Design effectiveness.* A control policy or procedure should be designed in a way that material misstatements to the financial statements will be prevented or detected in a timely manner.

- *Operating effectiveness.* Tests to evaluate operating effectiveness should allow management to evaluate how the control procedure was applied, the consistency with which it was applied, and by whom it was applied.

To be effective, the tests should have:

- Clearly stated objectives

- A design that is appropriate to achieve those objectives

- A scope and extent that is comprehensive enough to draw a reliable conclusion

Testing the Control Environment

The control environment has a significant influence on the operating effectiveness of the other components of the COSO integrated framework. The control environment is different from the other components in that it:

- Has an *indirect* effect on the amounts and disclosures reported in the financial statement, and

- Is *not* transaction-oriented. As such, it does not lend itself to transaction-oriented testing.

Testing the operating effectiveness of the control environment may pose a challenge for management. Documenting the control policies that make up the control environment is not sufficient to draw a conclusion about operating effectiveness. For example, the mere existence of a company code of conduct and its dissemination are not sufficient to allow management to conclude on the effectiveness of the related elements of the entity's control environment. Following the guidance provided here, tests must be performed to allow management to determine:

- How management, the board of directors, the audit committee, and the company employees applied the policies described in the code of conduct to their work
- The consistency with which individuals followed the guidelines contained in the code
- Who followed the code and who did not

In general, two approaches have begun to emerge for testing the control environment.

1. *Indirect*. Under this approach, management focuses its primary testing on activity-level controls. The results of those tests are evaluated carefully, and any deficiencies are investigated thoroughly to understand their root causes. Based on the information gained from these tests of activity-level controls, management is able to infer the relative effectiveness of the control environment.
2. *Direct*. Under this approach, management plans and performs tests to gather evidence directly about the operating effectiveness of the control environment. Such tests might include employee surveys, interviews with selected individuals, and the performance of a computer general controls review. Management uses the results of these tests of the control environment to design the activity-level tests.

The definitive guidance on internal control reporting does not express a preference for either approach. In the opinion of the author, directly testing the control environment will lead to more reliable conclusions about its operating effectiveness. Designing and performing these types of tests may be outside the realm of tests normally performed by audit or financial professionals; however, credentialed specialists in organizational development and other disciplines have developed tools and methodologies in this area that may be appropriate for management wishing to gain a direct understanding of an entity's control environment effectiveness.

Testing Activity-Level Controls

Assessing the Effectiveness of Design

Activity-level controls are effective when they can provide reasonable assurance that material financial statement errors will be prevented or detected in a timely fashion. To assess design effectiveness, management should consider:

- The general types of errors that could occur
- The points in the processing stream where errors may be introduced

After gaining an understanding of what could go wrong and where, management will then determine whether the system, as designed, adequately addresses these potential errors and error points.

Assessing Operating Effectiveness

Nature. Management will need to decide about the kinds of tests it will perform. For example, will the entity conduct inquiries, observe controls being performed, or reperform certain control procedures? The nature of the tests performed depends on the kind of control procedure being tested and whether its performance is documented.

Typically, management will perform a combination of one or more controls to gather evidence about their effective operations. It would be unlikely that one test will provide all the evidence needed to support a conclusion. An opinion about control effectiveness most likely will be formed by the congruence and consistency of the evidence gathered from several sources and kinds of tests.

Typical tests that management may choose from include:

- Tests of transactions
- Reperformance of control procedures
- Tests of computer application controls
- Inquiries
- Direct observation

Timing. The Sarbanes-Oxley Act requires management to report on the effectiveness of internal control as of a point in time, namely, year end. As a practical matter, many tests will be performed in advance of the reporting date. In those situations, management will need to consider the need to perform additional tests to establish the effectiveness of the control procedure from the time the tests were performed until the reporting date. For example, if the entity tests the effectiveness of bank reconciliations as of June 30 and the reporting date is December 31, management will need to consider performing tests to cover the period from July 1 through December 31. These tests may *not* require a repeat of the detailed tests performed at June 30 for the subsequent six-month period. Once management establishes the effectiveness of the control procedure at June 30, it may be able to support the effectiveness of the control at the reporting date indirectly through the consideration of entity-level controls and other procedures such as:

- The effectiveness of personnel-related controls such as the training and supervision of personnel who perform control procedures.
- The effectiveness of risk identification and management controls, including change management.
- The effectiveness of the monitoring component of the entity's internal control.
- Inquiries of personnel to determine what changes, if any, occurred during the period that would affect the performance of controls.
- Repeating the procedures performed earlier in the year, focusing primarily on elements of the control procedure that have changed during the period.

Reporting

The section of this Alert titled "The SEC Rules" describes what management's report on internal control must contain. However, the SEC has not mandated a prescribed form for management's report. Of the items required to be included in management's report, the one that calls for the most judgment is the following:

> Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

In its commentary to the final rules, the SEC requires management to state whether internal control is functioning effectively or not. "Negative assurance"—in which management states that "nothing came to its attention that would lead it to believe that internal control was not functioning effectively"—is not acceptable.

Material Weaknesses and Significant Deficiencies

Management is required to disclose any "material weakness" in the company's internal control. Further, the existence of one or more material weaknesses precludes management from concluding that its internal control is effective.

The SEC has stated that the meaning of the terms *material weaknesses* and *significant deficiencies* should be determined by reference to the auditing literature. Paragraphs 9 and 10 of the auditing standard provide the following definitions:

> 9. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.
>
> Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 10)

has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:
>
> a. *Probable.* The future event or events are likely to occur.
>
> b. *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
>
> c. *Remote*. The chance of the future events or events occurring is slight. Therefore, the likelihood of an event is "more than reasonably possible or probable."

Note: A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

10. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 8, 9 and 10 [*of the auditing standard*], and the directions in paragraphs 130 through 137 [*of the auditing standard*]. As explained in paragraph 23 [*of the auditing standard*], the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

Making Judgments About the Severity of Internal Control Deficiencies

Determining whether an internal control deficiency rises to the level of a material weakness will require management to consider:

- *Likelihood*, that is, the chance that the deficiency could result in a financial statement misstatement. When assessing likelihood, consider:
  - The relative importance of the control and whether the overall control objective is achieved by other control activities or a combination of control activities.
  - If the deficiency is an operating deficiency, the frequency of the operating failure rate. For example, numerous or repeated failures in the operation of a control would be more likely to be considered a significant deficiency than failures that are considered isolated occurrences.
  - Whether the control is automated and therefore could be expected to perform consistently over time.
- *Significance*, that is, the magnitude of potential misstatements resulting from the deficiency. When assessing significance, consider:
  - The nature of the account balance or classes of transactions affected by the deficiency and the financial statement assertions involved.
  - Whether the deficiency relates to an entity-level or activity-level control. Because entity-level controls can affect many account balances, classes of transactions, or financial statement assertions, weaknesses in entity-level controls that seem relatively insignificant by themselves could result in material financial statement misstatements.

Disclosures About Material Weaknesses

When a company identifies a material weakness, and such material weakness has not been remediated before its fiscal year end, it must conclude that its internal control over financial reporting is ineffective. The SEC staff believes that in such a case, companies should consider including the following in their disclosures:

- The nature of any material weakness
- Its impact on financial reporting and the control environment
- Management's current plans, if any, for remediating the weakness

Annual Reporting of Material Weaknesses That Have Been Corrected

Management is required to report on the effectiveness of internal control over financial reporting as of year end. In some cases, management may have identified and corrected a material weakness in internal control during an interim period. At issue is whether that corrected weakness is required to be reported in the entity's annual report on internal control.

To make that determination, management should consider whether the corrected deficiency has been operational for a period of time that is sufficient to draw a reliable conclusion about its operating effectiveness as of year end. Testing the corrected deficiency for design and operational effectiveness would be required to support management's conclusion. Before making its final decision regarding the reporting of a corrected deficiency, management should consult with its SEC legal counsel and the external auditors.

In addition, in July 2005, the PCAOB adopted Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*; this standard established a stand-alone engagement that is completely voluntary, performed at the company's request. Although the auditor's evaluation of the design and operating effectiveness of the identified controls generally follows the requirements of PCAOB Auditing Standard No. 2, this engagement is designed to be significantly narrower in scope because the auditor's testing is limited to the controls specifically identified by management as addressing the material weakness. Also, unlike an auditor's report on internal control over financial reporting, in which the assessment is required to be as of the date of the annual financial statements, an auditor's report on whether a material weakness continues to exist may be as of any date set by management. The PCAOB believes that in deciding whether to engage their auditors to report on whether a material weakness continues to exist, most companies will do so only when the benefits, such as renewed investor confidence, would outweigh the costs of such an audit. Auditing Standard No. 4 will become effective when ratified by the SEC.

Resource Central

On the Bookshelf

The following publications deliver valuable guidance and practical assistance related to internal control.

- *Internal Control—Integrated Framework* (product no. 990012kk), a paperbound version of the COSO report that established a common definition of internal control different parties can use to assess and improve their control systems. It also includes information on how to prepare external reports and five tools for evaluating each of the components identified in the framework.
- *Financial Reporting Fraud: A Practical Guide to Detection and Internal Control* (product no. 029879kk), a paperbound publication for CPAs in both public practice and industry. It uses case studies to provide information necessary to minimize fraud exposure for CPAs, employers, and clients.
- *Audit Committee Toolkit* (product no. 991001kk), a practice aid that brings you checklists, matrixes, questionnaires, and other materials that are designed to help the audit committee do the job it needs to do.

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Educational Courses and Training

The AICPA offers the following continuing professional education (CPE) courses related to internal control:

- *Internal Control Reporting for Public Companies*, a self-study course on CD (product no. 737132kk).
- *Internal Control and Design,* a CPE course, and *Internal Controls: Design and Documentation*, a CPE self-study course (product no. 731850kk), that provide information on regulatory requirements and techniques for meeting them. These courses explain why internal controls matter to management, auditors, and regulators; what makes up a good system; how internal controls can be both cost-effective and efficient; and how to create usable, affordable documentation.
- *Internal Control Reporting: Standards for Compliance*, a video CPE course.
- *Internal Control Reporting for Public Companies*, a July 17, 2003, Webcast that described what the SEC's final rules require of companies and who is affected. Available on CD-ROM (product no. 737132kk).

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APPENDIX

Frequently Asked Questions (From the U.S. Securities and Exchange Commission)

November 8, 2002 (Revised November 14, 2002)

The answers to these frequently asked questions represent the views of the Division of Corporation Finance. They are not rules, regulations nor statements of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved them.

Q1: Section 2(a)(7) of the Sarbanes-Oxley Act of 2002 (the "Act") defines an "issuer" as an "issuer (as defined in Section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78(c)), the securities of which are registered under Section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under Section 15(d)…." A company has offered and sold debt securities pursuant to a registration statement filed under the Securities Act of 1933, thus subjecting it to the reporting requirements of Section 15(d). The company did not register the debt securities under Section 12 of the Exchange Act of 1934. Subsequently, the company's reporting obligations have been statutorily suspended under Section 15(d) because it had fewer than 300 security holders of record at the beginning of its fiscal year. The company has not filed a Form 15 and has continued to file reports pursuant to its indenture. Is the company considered an "issuer" under the Act?

A1: No. Because the issuer had fewer than 300 security holders of record at the beginning of its fiscal year, the suspension is granted by statute and is not contingent on filing a Form 15. The definition of issuer applies only to issuers required to file reports. However, see Question 9 regarding these kinds of filers under Section 302 of the Act.

Q2: Will the rules relating to Section 301 apply to issuers whose securities are traded on the over-the-counter bulletin board market?

A2: No. Securities traded on the over-the-counter bulletin board market currently are not considered listed securities.

Q3: An issuer is filing a Form 10-K report after August 29, 2002, the date Rules 13a-14, 13a-15, 15d-14 and 15d-15 became effective, for a period ending prior to the effective date. Section V of Release No. 33-8124 provides that the certification required to be included with the report need contain only the statements set forth in paragraphs (b)(1), (2) and (3) of Exchange Act Rules 13a-14 and 15d-14. However, the instructions to Forms 10-Q, 10-QSB, 10-K, 10-KSB, 20-F and 40-F indicate that the required certification must be in the exact form set forth in the report. Must a certification filed during the transition period for a period ended before August 29th include the statements set forth in paragraphs (b)(4), (5) and (6) of Rules 13a-14 and 15d-14?

A3: No. Paragraphs (b)(4), (5) and (6) of Rules 13a-14 and 15d-14 need only be included for quarterly and annual reports, including transition reports, filed for periods ending after August 29, 2002.

Q4: Does an amended quarterly or annual report filed after August 29, 2002, the effective date of Rules 13a-14 and 15d-14, that amends a report filed prior to August 29, 2002 have to be certified?

A4: Yes. See note 48 of Release 33-8124. The certification need not include paragraphs (b)(4), (5) and (6) of Rules 13a-14 and 15d-14.

Q5: A company is filing a Form 10-Q/A for a period ending prior to the effective date of Rules 13a-14 and 15d-14. The amendment will neither contain nor amend financial statements. May the principal executive officer and principal financial officer omit paragraph 3 from the certifications?

A5: Yes. Since there will be no financial statements in the Form 10-Q/A, paragraph 3 may be omitted.

Q6: If an issuer has filed a Form 10-Q before the effective date of Rules 13a-14 and 15d-14, but needs to file an amended Form 10-Q after August 29, does the issuer need to provide the disclosure required by Item 307 of Regulation S-K?

A6: No.

Q7: Does the new Item 15 of Form 20-F apply to periods ending prior to August 29, 2002?

A7: Issuers must comply with Item 15(b) but not Item 15(a).

Q8: Does Section 302 apply to Forms 8-K filed by asset-backed issuers?

A8: No. Asset-Backed Issuers, as defined in Rules 13a-14(g) and 15d-14(g), do not need to file a certification with each Form 8-K. However, the certification that is filed with the Asset-Backed Issuer's Form 10-K will relate to certain Forms 8-K filed by the issuer in the preceding year. Please refer to Statement by the Staff of the Division of Corporation Finance of the Securities and Exchange Commission Regarding Compliance by Asset-Backed Issuers with Exchange Act Rules 13a-14 and 15d-14, dated August 27, 2002.

Q9: Is an issuer that is filing or submitting reports exclusively under Section 15(d) of the Exchange Act on a "voluntary" basis (for example, pursuant to a covenant in an indenture or similar document), due to a statutory suspension of the Section 15(d) filing obligation, subject to Rules 15d-14 and 15d-15 and the disclosure required by Item 307 of Regulations S-B and S-K?

A9: Yes. All companies filing or submitting reports under Section 13(a) or 15(d) must comply with those provisions whether or not a Form 15 has been filed pursuant to Rule 15d-6.

Q10: If only one other officer is certifying to the issuer's reports, is it permissible to revise paragraph 4 of the certification to make "other certifying officers" singular?

A10: Yes.

Q11: If an officer signs the certification without altering the wording to indicate he or she is providing the certification as principal financial officer, how will readers know whether the signatory is the principal executive officer or the principal financial officer?

A11: The officer should include his or her title under the signature.

Q12: If the same individual is both the principal executive officer and principal financial officer, must he or she sign two certifications?

A12: The individual may provide one certification and provide both titles underneath the signature.

Q13: A CEO resigned after the end of the quarter but before the filing of the upcoming Form 10-Q. The company appointed a new CEO prior to the filing. Who signs the certification?

A13: The new CEO because he or she is the principal executive officer at the time of the filing.

Q14: A company has a CEO who is resigning at the end of the year and is no longer performing the function of CEO although he is still employed with the company. In the interim, the company has another individual that is performing the functions of CEO. Can that other individual sign the certification despite the fact that the company still has another person with the CEO title?

A14: The person performing the function of CEO at the time of the filing should provide the certification. If it is not the person with the title of CEO, the company should disclose in the filing that the other individual is performing that function.

Q15: An issuer currently does not have a CEO/CFO. Who must execute the certifications required by Rules 13a-14 and 15d-14?

A15: As set forth in paragraph (a) of Rules 13a-14 and 15d-14, where an issuer does not have a CEO/CFO, the person or persons performing similar functions must execute the required certification.

Q16: Must co-principal executive officers (or co-principal financial officers) execute separate certifications or may both execute the same certification?

A16: Co-principal executive officers (or co-principal financial officers) should each execute separate certifications.

Q17: If Section 302 certifications are not included in, for example, a Form 10-K or 10-Q filing, and an amendment will be filed to include the certifications, must the entire document be re-filed or can the amendment include only the signature pages?

A17: Because the certification relates to the entire Form 10-K or 10-Q filing, the amendment should include the entire filing, not just the signature pages.

Q18: Using the same facts in question 17 above, if the amendment is not filed within the time period required for the periodic report, is the report deemed to be untimely?

A18: Yes. The periodic report will not be deemed timely for purposes of form eligibility and the issuer will not be deemed current until the amended periodic report containing the certification is filed.

Q19: A Canadian issuer is filing a Form F-10. Are certifications required because the Form F-10 incorporates prior Exchange Act filings?

A19: No.

Q20: What definition is the Commission currently using for internal controls and internal controls and procedures for financial reporting?

A20: In the release adopting the rules pursuant to Section 302 of the Act, the Commission noted the pre-existing concept of "internal controls" contained in Codification of Statements on Auditing Standards Section 319 ("AU Section 319"). See Release 33-8124 fn. 59 and accompanying text. In Release No. 33-8138, the Commission proposed defining "internal controls and procedures for financial reporting" by reference to AU Section 319, subject to any future modifications by the Public Company Accounting Oversight Board. Pending completion of rulemaking, the staff interprets both "internal controls and procedures for financial reporting" and "internal controls" for purposes of Exchange Act Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6) and Item 307 of Regulations S-B and S-K by reference to existing literature regarding generally accepted auditing standards, which would also be by reference to AU Section 319.

Q21: Are paragraphs (b)(5) and (b)(6) of Rules 13a-14 and 15d-14 currently operative given that there is no current requirement for evaluation of internal controls?

A21: Yes, these paragraphs are currently operative as to any filing relating to a period ending after August 29, 2002. See also Question 22.

Q22: New Exchange Act Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6) require an issuer's CEO and CFO to certify that:

> He or she and the other certifying officers have disclosed, based on their most recent evaluation, to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):
>
> - All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report

financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

- Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
- He or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

In addition, paragraph (b) of Item 307 of Regulations S-B and S-K requires an issuer to disclose whether or not there were significant changes in the issuer's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. Is a quarterly evaluation of internal controls or internal controls and procedures for financial reporting required at this time, and if so, what are the particular standards? How should the issuer respond to Item 307(b) of Regulations S-B and S-K? How should the issuer's CEO and CFO address this situation in their certification statements?

A22: Although proposed amendments to Exchange Act Rules 13a-15 and 15d-15 would impose a requirement on an issuer's management to conduct an evaluation, with the participation of the issuer's CEO and CFO, of the effectiveness of the issuer's internal controls and procedures for financial reporting (See Release No. 33-8138), the Commission's rules currently do not specifically require an issuer's CEO or CFO, or the issuer itself, to conduct periodic evaluations of the issuer's internal controls or the issuer's internal controls and procedures for financial reporting. Some elements of internal controls are included in the definition of disclosure controls and procedures.

There is a current evaluation requirement involving the CEO and the CFO of that portion of internal controls that is included within disclosure controls and procedures as part of the required evaluation of disclosure controls and procedures. We expect that issuers generally also would engage in an evaluation of internal controls. We believe that issuers generally currently evaluate internal controls, for example, in connection with reviewing compliance with Section 13(b) of the Exchange Act or in connection with the preparation or audit of financial statements.

In the case of Item 307(b) of Regulations S-K and S-B, to the extent that an issuer has conducted an evaluation of its internal controls as of the end of the period covered by the report, including under the circumstances described in the preceding paragraph, the issuer should disclose any significant changes to the internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. If the issuer has made any significant changes to internal controls or in other factors that could significantly affect these controls, such changes would presumably follow some evaluation, in which case the required disclosure must be made. If the issuer has made no significant changes, then no disclosure is required. This response is also applicable to Item 15(b) of Form 20-F and Item 6(c) of Form 40-F.

Regarding the certifications under Exchange Act Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6), the disclosures under Item 307 of Regulations S-B and S-K described above following any evaluations of internal controls, including in the circumstances described above in which the CEO or the CFO participates, would satisfy the requirements of paragraph (6). Paragraph (5) would currently require that disclosure be made by the CEO and the CFO to the issuer's auditors and the audit committee of its board of directors of any events enumerated in paragraph

(5) that have occurred of which the CEO or CFO become aware based on the most recent evaluation of internal controls, including in the circumstances described above, in which the CEO or CFO participates.

Q23: For purposes of Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6), what do the terms "significant deficiencies" and "material weaknesses" mean?

A23: For purposes of Rules 13a-14(b)(5) and (6) and 15d-14(b)(5) and (6), the meaning of the terms "significant deficiencies" and "material weaknesses" should be determined by reference to generally accepted auditing standards. See generally, AU Section 325.

Q24: Where the registrant is a limited partnership that does not have an audit committee, who should be considered the persons performing the equivalent function as referenced in new Exchange Act Rules 13a-14(b)(5) and 15d-14(b)(5)?

A24: Many limited partnerships do not have audit committees. Many general partners of limited partnerships are themselves limited partnerships. In this case, look through each general partner of the limited partnerships acting as general partner until a corporate general partner or an individual general partner is reached. With respect to a corporate general partner, the registrant should look to the audit committee of the corporate general partner or to the full board of directors as fulfilling the role of the audit committee. With respect to an individual general partner, the registrant should look to the individual as fulfilling the role of the audit committee.

Q25: If a company otherwise maintains a dividend reinvestment plan that satisfies the exemptive conditions of Rule 16a-11, are automatic dividend reinvestments under a nonqualified deferred compensation plan also eligible for the Rule 16a-11 exemption, so that those reinvestment transactions would not be required to be reported, thus reducing the number of Forms 4 due?

A25: Non-qualified deferred compensation plans are not Excess Benefit Plans, as defined by Rule 16b-3(b)(2) under the Exchange Act, in which transactions are exempted by Rule 16b-3(c). See Interpretive Letter to American Bar Association (Feb. 10, 1999, Q. 2(c)). Under Rule 16a-3(g)(1), as amended in Release 34-46421 (Aug. 27, 2002), each transaction in a non-qualified deferred compensation plan must be reported on a Form 4 not later than the end of the second business day following the day on which the transaction was executed. However, if a company maintains a dividend reinvestment plan that satisfies the exemptive conditions of Rule 16a-11, automatic dividend reinvestments under a non-qualified deferred compensation plan are also eligible for the Rule 16a-11 exemption. See Interpretive letter to American Home Products (Dec. 15, 1992).

Q26: In order to reduce the number of Forms 4 due annually, an insider makes the following choices: In connection with the annual year-end election to defer some of the following year's salary into a non-qualified deferred compensation plan, the insider elects to have payroll deductions invested in the plan's interest-only account. The insider also elects for the deferred salary so invested to be "swept" on a quarterly basis into the plan's stock fund account. How should these "sweep" transactions be reported?

A26: Each "sweep" transaction would be reportable separately on Form 4. If the "sweep" election satisfies the Rule 16b-3(f) exemptive conditions for Discretionary Transactions (as defined in Rule 16b-3(b)(1)), the "sweep" transactions would be reported using Code I. Further, if the reporting person does not select the date of execution for a "sweep" that is a Discretionary Transaction, Rules 16a-3(g)(3) and (4) would apply to determine the deemed execution date.

Q27: For purposes of satisfying the affirmative defense conditions of Rule 10b5-1(c), an insider adopts a written plan for the purchase or sale of issuer equity securities. In the plan, which was drafted by a broker-dealer, the broker-dealer specified the dates on which plan transactions will be executed. Can the insider rely on Rule 16a-3(g)(2) to compute the Form 4 due date for plan transactions based on a deemed execution date?

A27: No. By adopting a written plan that specifies the dates on which plan transactions will be executed, the insider will have selected the date of execution for plan transactions. Consequently, the insider will not be able to rely on Rule 16a-3(g)(2) to compute the Form 4 due date for plan transactions based on a deemed execution date.

Q28: When reporting more than one transaction on the same Form 4, what date should be stated in Box 4?

A28: The transaction date (not the deemed execution date) of the earliest transaction reported should be stated in Box 4.

(Revised October 6, 2004)[1]

The answers to these frequently asked questions represent the views of the staffs of the Office of the Chief Accountant and the Division of Corporation Finance. They are not rules, regulations or statements of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved them.

Q1: Financial Accounting Standards Board (FASB) Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51*, requires that registrants apply that guidance and, if applicable, consolidate entities based on characteristics other than voting control no later than the period ending March 15, 2004, or December 15, 2004 for small business issuers. In instances where the registrant lacks the ability to dictate or modify the internal controls of an entity consolidated pursuant to Interpretation No. 46, it may not have legal

1. On October 6, 2004, changes were made to clarify the answer to Question 3 (see footnote 2 and a cross reference added to Question 3 to reference the answer to Question 9), to describe a Type 2 SAS 70 report (see footnote 3) and to address new frequently asked questions (see Questions 19 through 23).

or contractual rights or authority to assess the internal controls of the consolidated entity even though that entity's financial information is included in the registrant's financial statements. Similarly, for entities accounted for via proportionate consolidation in accordance with Emerging Issues Task Force Issue No. 00-1 (EITF 00-1), management may not have the ability to assess the internal controls. How should management's report on internal control over financial reporting address these situations?

A1: We would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities, irrespective of the basis for consolidation. However, in a situation where the entity was in existence prior to December 15, 2003 and is consolidated by virtue of Interpretation No. 46 (i.e., would not have been consolidated in the absence of application of that guidance) and where the registrant does not have the right or authority to assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment, we believe management's report on internal control over financial reporting should provide disclosure in the body of its Form 10-K or 10-KSB regarding such entities. For example, a registrant could refer readers to a discussion of the scope of management's report on internal control over financial reporting in a section of the annual report entitled "Scope of Management's Report on Internal Control Over Financial Reporting." The registrant should disclose in the body of the Form 10-K or 10-KSB that it has not evaluated the internal controls of the entity and should also note that the registrant's conclusion regarding the effectiveness of its internal control over financial reporting does not extend to the internal controls of the entity. The registrant should also disclose any key subtotals, such as total and net assets, revenues and net income that result from consolidation of entities whose internal controls have not been assessed. The disclosure should note that the financial statements include the accounts of certain entities consolidated pursuant to FIN 46 or accounted for via proportionate consolidation in accordance with EITF 00-1 but that management has been unable to assess the effectiveness of internal control at those entities due to the fact that the registrant does not have the ability to dictate or modify the controls of the entities and does not have the ability, in practice, to assess those controls.

Q2: Is a registrant required to evaluate the internal control over financial reporting of an equity method investment?

A2: The accounts of an equity method investee are not consolidated on a line-by-line basis in the financial statements of the investor, and as such, controls over the recording of transactions into the investee's accounts are not part of the registrant's internal control structure. However, the registrant must have controls over the recording of amounts related to its investment that are recorded in the consolidated financial statements. Accordingly, a registrant would have to consider, among other things, the controls over: the selection of accounting methods for its investments, the recognition of equity method earnings and losses, its investment account balance, etc. For example, a registrant might require that, at least annually, its equity method investees provide audited financial statements as a control over the recognition of equity method earnings and losses. However, nothing precludes a registrant from evaluating the control over financial reporting of an equity method investment, and there may be circumstances where it is not only appropriate but also may be the most effective form of evaluation. For purposes of applying this guidance, we make no distinction between those equity method investments for which the registrant is required to file audited financial statements pursuant to Rule 3-09 of Regulation S-X and those where no such requirement is triggered.

Q3: If a registrant consummates a material purchase business[2] combination during its fiscal year, must the internal control over financial reporting of the acquired business be included in management's report on internal control over financial reporting for that fiscal year?

A3: As discussed above, we would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities. However, we acknowledge that it might not always be possible to conduct an assessment of an acquired business's internal control over financial reporting in the period between the consummation date and the date of management's assessment. In such instances, we would not object to management referring in the report to a discussion in the registrant's Form 10-K or 10-KSB regarding the scope of the assessment and to such disclosure noting that management excluded the acquired business from management's report on internal control over financial reporting. If such a reference is made, however, management must identify the acquired business excluded and indicate the significance of the acquired business to the registrant's consolidated financial statements. Notwithstanding management's exclusion of an acquired business's internal controls from its annual assessment, a registrant must disclose any material change to its internal control over financial reporting due to the acquisition pursuant to Exchange Act Rule 13a-15(d) or 15d-15(d), whichever applies (also refer to the last two sentences in the answer to question 9). In addition, the period in which management may omit an assessment of an acquired business's internal control over financial reporting from its assessment of the

2. The staff intends the term business to include those acquisitions that would constitute a business based upon the facts and circumstances as outlined in Article 11-01(d) of Regulation S-X. An acquisition may not meet the definition of a business in EITF 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*, and would not be accounted for under SFAS No. 141, *Business Combinations*, but nevertheless may be a business under the definition in Article 11 used for SEC reporting purposes. This guidance applies irrespective of whether the acquisition is significant under Rule 1-02(w) of Regulation S-X.

registrant's internal control may not extend beyond one year from the date of acquisition, nor may such assessment be omitted from more than one annual management report on internal control over financial reporting.

Q4: If management, the accountant, or both conclude in a report included in a timely filed Form 10-K or 10-KSB that the registrant's internal control over financial reporting is not effective, would the registrant still be considered timely and current for purposes of Rule 144 and Forms S-2, S-3, and S-8 eligibility?

A4: Yes, as long as the registrant's other reporting obligations are timely satisfied. As has previously been the case, the auditor's report on the audit of the financial statements must be unqualified.

Q5: May management qualify its conclusions by saying that the registrant's internal control over financial reporting are effective subject to certain qualifications or exceptions or express similar positions?

A5: No. Management may not state that the registrant's controls and procedures are effective except to the extent that certain problems have been identified or express similar qualified conclusions. Rather, management must take those problems into account when concluding whether the registrant's internal control over financial reporting is effective. Management may state that controls are ineffective for specific reasons. In addition, management may not conclude that the registrant's internal control over financial reporting is effective if a material weakness exists in the registrant's internal control over financial reporting.

Q6: If management's report on internal control over financial reporting does not identify a material weakness but the accountant's attestation report does, or vice versa, does this constitute a disagreement between the registrant and the auditor that must be reported pursuant to Item 304 of Regulation S-K or S-B?

A6: No, unless the situation results in a change in auditor that would require disclosure under Item 304 of Regulation S-K or S-B. However, such differences in identification of material weaknesses could trigger other disclosure obligations.

Q7: When should a registrant determine whether it is an accelerated filer for purposes of determining when it must comply with Items 308(a) and (b) of Regulations S-K and S-B?

A7: As provided in Exchange Act Rule 12b-2, a registrant that is not already subject to accelerated filing should determine whether it is an accelerated filer at the end of its fiscal year, based on the market value of its public float of its common equity as of the last business day of its most recently completed second fiscal quarter. Consideration should also be given to the other components of the Rule 12b-2 definition (i.e. the registrant has been subject to Exchange Act reporting for at least 12 months, has filed at least one annual report, and is not eligible to use Forms 10-KSB and 10-QSB).

Q8: Is a registrant required to provide management's report on internal control over financial reporting, and the related auditor attestation report, when filing a transition report on Form 10-K or 10-KSB?

A8: Yes. Because transition reports filed on Forms 10-K or 10-KSB (whether by rule or by election) must contain audited financial statements, they must also include management's report on internal control, subject to the transition provisions specified in Release No. 34-47986. The transition provisions relating to management's report on internal control should be applied to the *transition period as if it were a fiscal year*. Transition reports on Form 10-Q or 10-QSB are not required to include a management report on internal control.

Q9: Is a registrant required to disclose changes or improvements to controls made as a result of preparing for the registrant's first management report on internal control over financial reporting?

A9: Generally we expect a registrant to make periodic improvements to internal controls and would welcome disclosure of all material changes to controls, whether or not made in advance of the compliance date of the rules under Section 404 of the Sarbanes-Oxley Act. However, we would not object if a registrant did not disclose changes made in preparation for the registrant's first management report on internal control over financial reporting. However, if the registrant were to identify a material weakness, it should carefully consider whether that fact should be disclosed, as well as changes made in response to the material weakness.

After the registrant's first management report on internal control over financial reporting, pursuant to Item 308 of Regulations S-K or S-B, the registrant is required to identify and disclose any material changes in the registrant's internal control over financial reporting in each quarterly and annual report. This would encompass disclosing a change (including an improvement) to internal control over financial reporting that was not necessarily in response to an identified significant deficiency or material weakness (i.e. the implementation of a new information system) if it materially affected the registrant's internal control over financial reporting. Materiality, as with all materiality judgments in this area, would be determined upon the basis of the impact on internal control over financial reporting and the materiality standard articulated in TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438 (1976) and Basic Inc. v. Levinson, 485 U.S. 224 (1988). This would also include disclosing a change to internal control over financial reporting related to a business combination for which the acquired entity that has been or will be excluded from an annual management report on internal control over financial reporting as contemplated in Question 3 above. As an alternative to ongoing disclosure for such changes in internal control over financial reporting, a registrant may choose to disclose all such changes to internal control over financial reporting in the annual report in which its assessment that encompasses the acquired business is included.

Q10: The definition of the term "internal control over financial reporting" does not encompass a registrant's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements. Are all aspects of the rules promulgated under the Sarbanes-Oxley Act, for example, within that definition?

A10: No. While, it may be possible to connect the violation of any law, rule or regulation to the financial statements by observing that if the violation is significant enough it will have a material impact on the registrant's financial statements, we do not believe that compliance with all laws fits within the definition. The Commission's financial reporting requirements and the Internal Revenue Code are examples of regulations that are directly related to the preparation of the financial statements. Conversely, rules requiring disclosure as to the existence of a code of ethics or disclosure as to the existence of an audit committee financial expert are examples of rules promulgated under the Sarbanes-Oxley Act that are not directly related to the preparation of financial statements.

However, as part of management's evaluation of a registrant's disclosure controls and procedures, management must appropriately consider the registrant's compliance with other laws, rules and regulations. Such consideration should include assessing whether the registrant (1) adequately monitors such compliance, and (2) has appropriate disclosure controls and procedures to ensure that required disclosure of legal or regulatory matters is provided. Evaluation of disclosure controls and procedures and internal control over financial reporting in respect of compliance with applicable laws or regulations does intersect at certain points, including, for example, whether the registrant has controls to ensure that the effects of non-compliance with laws, rules and regulations are recorded in the registrant's financial statements, including the recognition of probable losses under FASB Statement No. 5, *Accounting for Contingencies.*

Q11: Must identified significant deficiencies be disclosed either as part of management's report on internal control over financial reporting or elsewhere in a registrant's periodic reports?

A11: A registrant is obligated to identify and publicly disclose all material weaknesses. If management identifies a significant deficiency it is not obligated by virtue of that fact to publicly disclose the existence or nature of the significant deficiency. However, if management identifies a significant deficiency that, when combined with other significant deficiencies, is determined to be a material weakness, management must disclose the material weakness and, to the extent material to an understanding of the disclosure, the nature of the significant deficiencies. In addition, if a material change is made to either disclosure controls and procedures or to internal control over financial reporting in response to a significant deficiency, the registrant is required to disclose such change and should consider whether it is necessary to discuss further the nature of the significant deficiency in order to render the disclosure not misleading. A registrant's auditor that is aware of a significant deficiency is required to communicate the significant deficiency to the audit committee as required by PCAOB Auditing Standard No. 2.

Q12: Many registrants with global operations have a lag in reporting the financial results of certain foreign subsidiaries for financial reporting purposes. For example, a registrant with a December 31 year-end may consolidate the operations of certain foreign subsidiaries with a November 30 year-end. Is this difference in period ends also acceptable in relation to the assessment of internal control over financial reporting?

A12: Yes.

Q13: The Commission's adopting release for its rules pursuant to Section 404 of the Sarbanes-Oxley Act (Release No. 34-47986) provides that the terms "significant deficiency" and "material weakness" have the same meaning for purposes of those rules as they do under generally accepted auditing standards and attestation standards. PCAOB Auditing Standard No. 2 modified the definitions of the terms "significant deficiency" and "material weakness." Does the Commission staff intend to look to the definitions as they existed when the adopting release was issued or as they have been revised by the PCAOB?

A13: When the Commission published its adopting release, the Commission expressed an intention to incorporate the definitions of "significant deficiency" and "material weakness" as they exist in the standards used by auditors of public companies. Looking to the definitions as revised by the PCAOB is consistent with this intention and, accordingly, the SEC staff will apply the PCAOB definitions in interpreting the Commission rules in this area.

Q14: In many situations, a registrant relies on a third party service provider to perform certain functions where the outsourced activity affects the initiation, authorization, recording, processing or reporting of transactions in the registrant's financial statements, such as payroll. In assessing internal controls over financial reporting, management may rely on a Type 2 SAS 70 report[3] performed by the auditors of the third party service providers. If the auditors of the third party service provider are the same as the auditors of the registrant, may management still rely on that report? Additionally, may management rely on a Type 2 SAS 70 report on the third party based on a different year-end?

3. AU sec 324 defines a report on controls placed in operation and test of operating effectiveness, commonly referred to as a "Type 2 SAS 70 report". This report is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

A14: In situations where management has outsourced certain functions to third party service provider(s), management maintains a responsibility to assess the controls over the outsourced operations. However, management would be able to rely on the Type 2 SAS 70 report even if the auditors for both companies were the same. On the other hand, if management were to engage the registrant's audit firm to also prepare the Type 2 SAS 70 report on the service organization, management would not be able to rely on that report for purposes of assessing internal control over financial reporting. Management would be able to rely on a Type 2 SAS 70 report on the service provider that is as of a different year-end. Note, however, that management is still responsible for maintaining and evaluating, as appropriate, controls over the flow of information to and from the service organization.

Q15: What is the impact of combining the auditor's attestation report on management's assessment of internal controls over financial reporting with the audit report on the financial statements?

A15: Item 2-02 of Regulation S-X permits the auditor to combine the attestation report on management's assessment on internal control with the auditor's report on the financial statements. However, in determining whether to combine the reports, the auditor should take into account any issues that may arise if its audit report on the financial statements is expected to be reissued or incorporated by reference into a filing under the Securities Act.

Q16: Will the SEC be providing guidance on specific considerations relating to internal control over financial reporting for small business issuers?

A16: Although the Commission's final rule implementing Section 404 of the Act does not distinguish between large and small issuers, the Commission, as noted in the release accompanying the final rule, recognized that many smaller issuers might encounter difficulties in evaluating their internal control over financial reporting. The SEC staff would support efforts by bodies such as COSO to develop an internal control framework specifically for smaller issuers.

Q17: To what extent may management rely on the registrant's auditor to assist in its development of an assessment process and documentation process in preparation of issuing management's report on internal control over financial reporting?

A17: The auditor is allowed to provide limited assistance to management in documenting internal controls and making recommendations for changes to internal controls. However, management has the ultimate responsibility for the assessment, documentation and testing of the registrant's internal controls over financial reporting.

Q18: What sources of guidance are available to management to assist them in fulfilling their responsibilities regarding management's assessment and documentation of the internal control over financial reporting?

A18: Several sources of guidance are available on the topic of management's assessment of internal control including, for example: the existing books and records requirements; the Commission's final rule on Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (Release No. 34-47986); and, as referenced in the release on the final rule, the reports published by the Committee of Sponsoring Organizations of the Treadway Commission on internal control.

Q19: How should management treat an inability to assess certain aspects of their internal control over financial reporting in their written report? For example, management has outsourced a significant process to a service organization and it has determined that evidence of the operating effectiveness of the controls over that process is necessary. In addition, the service organization is unwilling to provide either a Type 2 SAS 70 report or access to assess the controls in place at the service organization. Finally, management does not have compensating controls in place within the registrant's internal control over financial reporting that allow them to determine the effectiveness of the controls over the process in an alternative manner.

A19: Item 308 of Regulations S-K and S-B, 17 CFR 229.308(a)(3) and 228.308(a)(3), states that management's annual report on internal control over financial reporting must include a statement as to whether or not internal control over financial reporting is effective. While the staff will allow the exceptions outlined in Questions 1, 2, and 3 above, the disclosure requirement does not permit management to issue a report on internal control over financial reporting with a scope limitation. Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in their report that internal control over financial reporting is not effective. Further, management is precluded from concluding that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the internal control over financial reporting.

Q20: The Commission's rules specify that management's report must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management in the course of its evaluation. Must management's report specifically use the term "material weakness"?

A20: While the Commission's rule does not require management to use any specific language in their report, the staff would generally expect that, in order for management to provide full disclosure relating to any material weakness identified by management, management would use the term "material weakness" in their disclosures.

Q21: If a Form 10-K or Form 10-KSB is incorporated into a 1933 Securities Act filing, is a consent required related to the auditor's report on management's assessment of internal control over financial reporting?

A21: Yes. Securities Act Rule 436 (17 CFR 230.436) requires filings under the 1933 Act to include a consent for all accountants' reports included or incorporated into that filing. This includes a consent for the auditor's report on management's assessment of internal control over financial reporting as well as the auditor's report on the financial statements. A new consent for the auditor's report on management's assessment of internal control over financial reporting is required in an amendment to the registration statement (a) whenever a change, other than typographical is made to the audited annual financial statements and (b) when facts are discovered that may impact the auditor's report on management's assessment of internal control over financial reporting.

Q22: Is an annual report to shareholders that meets the requirements of Exchange Act Rules 14a-3(b) or 14c-3(a) required to include management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting?

A22: We believe that the intent of Section 404 of the Sarbanes-Oxley Act and the Commission's rules is that a registrant's audited financial statements with an accompanying audit report that are contained in or accompany a proxy statement or consent solicitation statement also be accompanied by management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting. We intend to recommend to the Commission that amendments be made to Rules 14a-3 and 14c-3(a) and Item 13 of Schedule 14A to include such a requirement. In the interim, we encourage issuers to include both management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting in the annual report to shareholders when their audited financial statements are included. If management states in their report that internal control over financial reporting is ineffective or the auditor's report takes any form other than an unqualified opinion and these reports are not included in the annual report to shareholders, our view is that an issuer would have to consider whether the annual report to shareholders contained a material omission that made the disclosures in the annual report misleading.

Q23: The Commission's rules implementing Section 404, announced in Release No. 34-47986, require management to perform an assessment of internal control over financial reporting which includes the "preparation of financial statements for external purposes in accordance with generally accepted accounting principles." Does management's assessment under the Commission's rule specifically require management to assess internal control over financial reporting of required supplementary information? Supplementary information includes the financial statement schedules required by Regulation S-X as well as any supplementary disclosures required by the FASB. One of the most common examples of such supplementary information is certain disclosures required by the FASB Standard No. 69, *Disclosures about Oil and Gas Producing Activities.*

A23: Adequate internal controls over the preparation of supplementary information are required and therefore should be in place and assessed regularly by management. The Commission's rules in Release No. 34-47986 did not specifically address whether the supplementary information should be included in management's assessment of internal control over financial reporting under Section 404. A question has been raised as to whether the supplementary information included in the financial statements should be encompassed in the scope of management's report on their assessment of internal control over financial reporting.

The Commission staff is considering this question for possible rule making. Additionally, the Commission staff is evaluating broader issues relating to oil and gas disclosures and will include in its evaluation whether rulemaking in this area may be appropriate. Should there be any proposed changes to the current requirements in this area, they will be subject to the Commission's standard rulemaking procedures, including a public notice and comment period in advance of rulemaking. As a result, internal control over the preparation of this supplementary information need not be encompassed in management's assessment of internal control over financial reporting until such time that the Commission has completed its evaluation of this area and issues new rules addressing such requirements.

Until then, registrants are reminded that they must fulfill their responsibilities under current requirements including Section 13(b)(2) of the Exchange Act and Exchange Act Rules 13a-14, 13a-15, 15d-14, and 15d-15.

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